No. 88-1474

IN THE

Supreme Court of the United States

OCTOBER TERM, 1989

UNITED STATES OF AMERICA,

Petitioner,

v.

THE GOODYEAR TIRE & RUBBER COMPANY AND AFFILIATES,

Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Federal Circuit

BRIEF FOR AMICUS CURIAE NATIONAL FOREIGN TRADE COUNCIL, INC.

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With the consent of the parties, as evidenced by letters on file with the Clerk, the National Foreign Trade Council, Inc., submits this brief amicus curiae in support of the position of the respondent Goodyear.

INTEREST OF THE AMICUS CURIAE

The amicus curiae National Foreign Trade Council, Inc., is a trade association established in 1914 consisting of more than 400 constituents engaged in all aspects of international investments, operations and trade. Many of the NFTC members are United States corporations with subsidiaries or branches in foreign countries. The NFTC constituents therefore are vitally concerned with the issue that this case presents of the meaning of Section 902 of the Internal Revenue Code.

STATEMENT

The Goodyear Tire & Rubber Company, together with its domestic affiliates that file a consolidated federal income tax return with it, is the respondent here. Goodyear has another subsidiary, The Goodyear Tyre & Rubber Company (Great Britain), Ltd. By law that subsidiary, Goodyear UK, as a foreign corporation, is not allowed to join in the consolidated return. However, when Goodyear receives dividends from Goodyear UK and pays United States income tax on them, it is entitled to a credit for any foreign income tax paid on profits related to the dividends. That credit is granted to prevent double taxation.

The case concerns the extent of Goodyear's deemed-paid credit under Section 902(a)(1) of the Internal Revenue Code ("deemed-paid" because the United States taxpayer does not directly pay the foreign tax) for 1970 and 1971. The British tax authorities allowed Goodyear UK deductions in 1973 that produced a loss in that year. When carried back to 1971 (1972 was already a loss year), the 1973 loss wiped out all the profits on which Goodyear UK had paid a British income tax in that year and therefore all the tax. What was left of the 1973 loss was carried back farther to 1970 and wiped out all but a little of the profit and the tax of that year.

As a consequence of the loss carryback, Goodyear recomputed its foreign taxes deemed paid with respect to the dividends it received from Goodyear UK by associating those dividends with profits that Great Britain had already accounted for and taxed, *i.e.*, profits realized in earlier years. The Internal Revenue Service, on the other hand, proposed to associate the dividends with the profits that Goodyear UK originally reported for 1970 and 1971. The reason for this treatment, it said, was that it would not have recognized in 1973, for a United States corporation paying United States income tax, the British deductions that caused the 1973 loss that all but eliminated Goodyear UK's 1970 and 1971 profits. When the constructive profits

of 1970 and 1971 generated by this proposed application of United States tax law to a foreign operation were associated with the minimal tax actually paid under the foreign tax law that determined the tax, the result under the statutory formula for computing the deemed-paid tax credit was a very small credit.

The different computations of the deemed-paid credit produced a difference of more than half a million dollars in Goodyear's tax liability. Goodyear paid the deficiency that the Service asserted and sued in the Claims Court for a refund. The Claims Court decided for the Government. On appeal, the Court of Appeals for the Federal Circuit held that foreign law governed, as Goodyear asserted, and reversed.

SUMMARY OF ARGUMENT

The issue in this case is the meaning of the term "accumulated profits" as used in Section 902(a)(1) of the Internal Revenue Code as the section read before it was substantially revised in 1986. Accumulated profits are a principal element in a statutory formula that Section 902(a)(1) prescribes for relating a dividend that a United States shareholder receives in one taxable year to the profits a foreign corporation earns over a course of years. This determination dictates how much credit the shareholder, as a United States income taxpayer, receives for foreign income taxes imposed with respect to the profits that made possible the payment of a taxable dividend by a foreign corporation in which it has an interest.

1. Textual and contextual analysis demonstrates that a foreign corporation's accumulated profits, statutorily defined as its "gains, profits, or income," are to be determined according to the foreign tax law that governs the amount of the foreign tax that—in the words of the statute—is paid or imposed "on or with respect to" such gains, profits or income. That meaning of accumulated profits is confirmed by the statutory history of the deemed-paid tax credit, which this Court considered in *American Chicle Co.* v. *United States*, 316 U.S. 450 (1942).

2. Only if accumulated profits are measured according to foreign tax law rules does Section 902(a)(1) fulfill its purposes of (a) preventing double taxation; (b) ensuring that the deemed-paid tax credit properly reflects the actual foreign tax borne by the income used to pay the dividends received by and taxed to the United States corporate parent; and (c) ensuring equitable treatment of United States taxpaying corporations that operate abroad through branches, on the one hand, and through subsidiaries on the other. When foreign tax rules are used, those purposes are served and there is no risk of a windfall for the United States taxpayer or harm to the Treasury.

3. Neither administrative nor judicial precedent argues for the Government's position that accumulated profits are determined by the application of United States tax rules, a position that cannot claim a solid source even in the regulations to which the Government asks this Court to defer.

ARGUMENT

Those who pay a United States income tax receive a credit for any foreign income tax they have paid on the same income. I.R.C. §§ 33, 901 (1970) (Gov't Br. la). Section 902 of the Code (Gov't Br. 2a-4a) affords an equivalent credit to a United States corporation that is the parent of or has an interest of as little as 10 percent in a foreign corporation that pays it a dividend.[1] The credit in that case is for foreign tax that the United States corporate taxpayer has not in fact paid but is "deemed to have paid" because the tax was paid by the foreign dividend payor on or with respect to the profits that made possible the

[1] Section 902(a)(1) as it appears in the appendix to the Government's brief is the statute as it read in the tax years 1970 and 1971, with which this case deals. The Federal Circuit in its opinion (Pet. 4a) quoted the statute as it read just before it was revised in 1986. Our references to and descriptions of Section 902 will generally be to and of the 1970-71 version. As the Court knows from the presentations of the parties, Section 902 was thoroughly revised in 1986 for tax years beginning after December 31, 1986.

payment of the dividend. The deemed-paid credit has the same purpose as the credit for foreign income taxes paid directly: the avoidance of double taxation.

When a wholly owned foreign subsidiary pays out as a dividend in a year all of the annual profits left after it has paid its foreign income tax, its United States parent is entitled to a deemed-paid credit for the full amount of the foreign income tax paid. If, however, a foreign corporation is less than wholly owned or if a wholly owned subsidiary in a particular year distributes only a part of what is available after payment of the foreign tax, the credit should obviously not be for the full amount of the foreign tax. There has to be a way of determining how much of the foreign tax paid in a year should be attributed to the dividend received by the United States corporation in that year (and, over time, to dividends received in subsequent years that are paid out of any income retained in the first year). As the parenthetical addition to the last sentence suggests, there may also be years in which a subsidiary's dividend to a parent exceeds its profits for the year of the dividend. To ensure a full credit, there has to be a way of tracing that dividend or a part of it back to the tax paid when the retained income now being distributed was earned.

Congress prescribed in Section 902(a)(1) a formula for computing the credit. Featuring the concept of accumulated profits, the formula permits the apportionment of the foreign tax paid in any year and the tracing, or sourcing, of dividends to the years of the profits that made them possible. According to the formula, the tax credit (C) is equal to the total foreign income tax paid by the foreign dividend payor (T) times the dividend (D) divided by the payor's accumulated profits (P) minus the total foreign tax (again T). Thus, $C = T(D/(P-T))$.

The issue in this case is the meaning of accumulated profits. The court below held that "the plain meaning of the statute" is that these are profits determined according to the foreign nation's tax laws. (Pet. 6a.) The Government

calls this conclusion "counterintuitive" (Gov't Br. 14) even though the section of the Code we are concerned with deals with a foreign corporation paying a foreign tax under foreign law. The Government proposes a definition that, as shown by its proposed treatment of Goodyear UK, makes the size of a foreign corporation's profits on which a foreign tax is paid a function of United States tax law.

In what follows we shall urge that the court of appeals' reading of Section 902 is the correct reading—the reading that is required by its text and context, accords with its history, and best carries out the policy of the section—and that, contrary to the Government's arguments, no administrative practice or precedent requires a different reading.

I. THE TEXT AND CONTEXT OF SECTION 902(a)(1) REQUIRE THAT ACCUMULATED PROFITS OF A FOREIGN CORPORATION ARE DETERMINED BY FOREIGN TAX LAW.

A. A Straightforward Reading of Section 902(a)(1) Is That a Foreign Corporation's Accumulated Profits Are Its Profits Determined According to the Law of the Foreign State Taxing Them.

Section 902(a)(1) says that "a domestic corporation which owns at least 10 percent of the voting stock of a foreign corporation from which it receives dividends in any taxable year shall . . . be deemed to have paid the same proportion of" income taxes paid by the foreign corporation to a foreign country "on or with respect to . . . accumulated profits," as defined in Section 902(c)(1)(A) that the amount of the dividends "bears to the amount of such accumulated profits" minus the income taxes paid. Section 902(c)(1)(A) (Gov't Br. 3a-4a) defines accumulated profits, for purposes of Section 902(a)(1), as a foreign corporation's "gains, profits, or income" without reduction for the amount of any income "taxes imposed on or with respect to such profits or income" by a foreign country.

Thus, on the face of Sections 902(a)(1) and 902(c)(1)(A), accumulated profits and their definitional equivalent, gains, profits or income, are something on or with respect to

which a foreign income tax is paid or imposed. The foreign tax is the beginning point in Section 902(a)(1). It is an amount over which United States taxing authorities and United States tax law have no control. The foreign tax is a percentage of the foreign tax base, the corporation's net income or profits. In that way the foreign tax is—using the words of Section 902—"imposed" or "paid" "on or with respect to" the tax base. The foreign tax base is, we submit, what Section 902(a)(1) calls "accumulated profits" and Section 902(c)(1)(A), in turn, refers to as "gains, profits, or income." United States tax law is as extraneous to the determination of accumulated profits or gains, profits or income so understood as it is to the determination of the tax that is paid or imposed on or with respect to the accumulated profits or gains, profits or income.

There is no reason to believe, and every reason not to believe—it is counterintuitive, shall we say—that Congress meant accumulated profits, a phrase used only in respect of foreign corporations and their foreign taxes, to refer to gains, profits or income measured according to the rules of United States tax law. Yet this is precisely what the Government advocates: an extraterritorial application of United States tax law to define items of gross income and allowable deductions of a foreign corporation and assign them to particular tax years, thereby constructing an artificial tax base that is not the base for the actual foreign tax. To the extent that United States tax law defines items of gross income and allowable deductions differently from foreign tax law or assigns them to different years from those to which foreign law assigns them, the amount so determined at times will be greater and at times less than the amounts "on or with respect to" which the foreign tax was imposed. The foreign tax paid by the foreign corporation thus will not match the corporation's gains, profits or income, and neither will the credit, as the statute contemplates that it should.

B. The Government's Reading of Section 902(a)(1) Is Not Supported by the Text of the Section.

Precisely what concept in United States tax law the Government believes that "accumulated profits" are the equivalent of is not clear. Below, the Government seemed to urge that a foreign corporation's "accumulated profits" were or approximated what its taxable income would have been if determined according to United States law. (*See* J.A. 21, ¶ 7 of stipulation). That position at least had the virtue that taxable income, like accumulated profits, is a pre-tax figure and, like accumulated profits (*see* Gov't Br. 4 n.4, 17 n.6, 25 n.11), is an annual figure. But that position has the fatal flaw of lacking any foundation whatever in the text of Section 902. It is, moreover, irreconcilable with the statutory reporting provision associated with Section 902. I.R.C. § 6038(a)(1)(B) (p. 12, *infra*.). The Government does not press the argument here, presumably because of its indefensibility, although there remain traces of it in the brief. Instead, the Government now seems to turn to United States "earnings and profits" as the claimed equivalent of accumulated profits, although here too its position is vague and fuzzy. It typically uses such uncertain phrases as "defined under principles of United States taxation" (Gov't Br. 32) or "determined by United States law" (*id.* at 33).

While thus eschewing precisely to equate a foreign corporation's accumulated profits with United States earnings and profits, the Government draws heavily in its argument on the fact that Section 902(a)(1) uses the term "dividends" and refers to dividends' being paid out of "accumulated profits." (Gov't Br. 3, 18, 42-43.) Dividend is a term of art in United States tax law. A dividend is a corporate distribution that is paid out of a corporation's earnings and profits. I.R.C. § 316.

But it does not follow, as the Government contends, that, because statutory dividends can be paid only out of earnings and profits, accumulated profits in Section 902(a)(1) must mean United States earnings and profits or

something that "should accord with" (Gov't Br. 12) United States earnings and profits. To the contrary, the two terms cannot rationally be equated. In the first place, though this is not conclusive, earnings and profits by their nature are an *after*-tax concept: they are the amount available for the payment of dividends. On the other hand, accumulated profits in Section 902(a)(1) are, by the Section 902(c)(1)(A) definition, a *before*-tax amount.[2]

Furthermore, earnings and profits generally are cumulative; there is a concept of annual earnings and profits, but earnings and profits most commonly designate the amount left in a corporation's surplus at any time as a result of the profits realized and losses incurred and income taxes and dividends paid over time. Accumulated profits—despite their name—"are computed on a year-by-year basis," which distinguishes them from earnings and profits, as the Government quietly acknowledges (Gov't Br. 25 n.11). *See General Foods Corp.* v. *Commissioner*, 4 T.C. 209 (1944), *acq.* 1946-1 C.B. 2.

Finally, earnings and profits—even a particular year's earnings and profits—are not an amount that an annual income tax is paid or imposed "on or with respect to." A year's earnings and profits before taxes (which is really a contradiction in terms) are not simply the equivalent of a year's corporate taxable income. As an elementary example, a corporation might own tax-free municipal bonds, the interest on which would enter into its earnings and

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[2] It is true that in the predecessor to Section 902(a)(1) construed in American Chicle Co. v. United States, 316 U.S. 450 (1942), and, indeed, all predecessors up to 1962, accumulated profits were after-tax profits. And there is no indication that it was thought that the basic concept of accumulated profits was changed by the 1962 amendment, 76 Stat. 960, 999-1001. *See* H.H. Robertson Co. v. Commissioner, 59 T.C. 53, 78 (1972), *aff'd*, 500 F.2d 1399 (3d Cir. 1974). Given the inconsistency of the post-1962 wording of Section 902(a)(1) with an equation of accumulated profits and earnings and profits, that can only mean that the pre-1962 predecessors could not have meant earnings and profits when they said accumulated profits, and Congress so understood when it acted in 1962.

profits as a legitimate source of dividends but not of course into its taxable income. Section 312 of the Code sets out a long catalogue of factors that enter into the computation of earnings and profits and differ from the factors pertinent to calculating annual taxable income.

All the uses of the phrase "accumulated profits" in Section 902(a)(1) can be harmonized, however, as the Government's reading of the section, emphasizing the payment of dividends "out of" accumulated profits, does not. The first proposition is that the phrase describes, foremost, the amount on or with respect to which the foreign taxes are paid. The next proposition is that the unqualified term "dividends" in the introductory paragraph of Section 902(a)(1) by itself amply demonstrates that the amount against which a credit may be allowed is a distribution to the United States parent from earnings and profits; no reference to accumulated profits is necessary to that conclusion. The further point is that a dividend, already defined as a distribution out of earnings and profits, is also paid out of or from the gains, profits or income of the foreign corporation as measured by foreign law. Congress thus used the concept of accumulated profits for a purpose quite other than limiting the application of Section 902(a)(1) to United States taxable dividends. It used accumulated profits in describing the temporal relationship of the dividend to the corporation's gains, profits or income in order to enable the United States taxpayer to trace the source of a dividend, as appropriate, to a year or years in which a foreign tax was paid on the accumulated profits that support the dividend.

C. Contrasting Use in Other Provisions of the Code and Other Contextual Evidence Reinforce the Plain Meaning of the Term Accumulated Profits in Section 902(a)(1).

When Congress wants to specify the use by taxpayers of earnings and profits of foreign corporations, measured as nearly as possible according to United States law, it says so. It has said so in Subpart F of the Code, added

in 1962.[3] That series of sections provides for the imputation to a United States shareholder of certain income of a United States-controlled foreign corporation without the necessity of any dividend actually being paid. Because Subpart F in effect treats dividends as paid even though they have not been paid, Section 952(c) of the Code provides that the income that is imputed, known as Subpart F income, may not "exceed the earnings and profits of" a controlled foreign corporation for a taxable year.

Correspondingly, another provision of Subpart F, Section 960, as it read in the tax years in issue here, established a formula, similar to the formula of Section 902(a)(1), for computing a deemed-paid tax credit for foreign income tax paid on or with respect to any part of a foreign controlled corporation's earnings and profits imputed to a domestic corporation. In Section 964, yet another Subpart F provision, Congress recognized the difficulty of calculating the earnings and profits of a foreign corporation, and provided that, for the purposes of Subpart F, earnings and profits should be "determined according to rules substantially similar to those applicable to domestic corporations" set forth in regulations. There is no such recognition of problems of calculation in Section 902 because the use of earnings and profits (except to ascertain in the first instance whether a distribution is a dividend) is not contemplated.[4]

Adding to the contextual significance of the striking dissimilarity of the words Congress chose for Section 902,

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[3] Subpart F of Part III, Chapter 1N, Subtitle A, Internal Revenue Code. I.R.C. §§ 951-64.

[4] There is usually leeway in a foreign corporation's surplus account, however computed, for paying a dividend, so that the need to compute its United States earnings and profits to ascertain whether a distribution is a dividend to its United States parent is more theoretical than burdensome. On the other hand, a year-by-year calculation of a foreign corporation's United States earnings and profits to work the Section 902(a)(1) formula could be very burdensome, requiring calculations not required for any other business, taxation or regulatory purpose.

on the one hand, and Section 960 on the other is the fact that, when Subpart F was added to the Code in 1962, Section 902 was substantively amended (P. 9 n. 2, *supra*), but its wording was not made to conform with that of the new and parallel Section 960 formula for computing a deemed-paid tax credit. Congress, while using "earnings and profits" in the new provision, stayed with "accumulated profits" in the existing provision it was amending—a singular decision if the two phrases were intended to be synonymous.

There is one final piece of compelling contextual evidence that Congress did not mean that accumulated profits should be calculated according to United States tax standards. Section 6038(a)(1)(B) of the Code requires a United States person controlling a foreign corporation to furnish the IRS with certain information regarding the subsidiary. Until the law was changed in 1986, one of the items that had to be submitted was a statement showing

> "the accumulated profits (as defined in section 902(c)) of such foreign corporation or foreign subsidiary, including the items of income (*whether or not included in gross income under Chapter 1*), deductions (*whether or not allowed in computing taxable income under Chapter 1*), and any other items taken into account in computing such accumulated profits." (Emphasis added.)

Obviously, if Congress had thought that accumulated profits meant taxable income calculated according to United States tax law, it would not have used the italicized phrases. If it had meant that accumulated profits should equal earnings and profits, it would have said that and probably referred to the Section 312 catalogue of items that differentiate earnings and profits from taxable income. What it did mean was that accumulated profits were defined by foreign standards.

D. The History of Section 902(a)(1) Confirms the Reading Demanded by Its Text and Context.

The history of Section 902 confirms the reading of the section demanded by its text and context. The "deemed-paid" credit for foreign taxes entered the tax code in 1918 at the same time as the foreign tax credit itself. The formula set forth in Section 240(c) of the Revenue Act of 1918, 40 Stat. 1082, the forebear of the Section 902(a)(1) formula, was more rudimentary. The credit was for the proportion of foreign income taxes that "the amount of any dividends" received by the domestic parent corporation from the foreign subsidiary bore "to the total taxable income of such foreign corporation upon or with respect to which such taxes were paid." The Court of Appeals for the Second Circuit was to say that it seemed "entirely clear" that "the words, 'the total taxable income * * * upon * * * which such taxes were paid', means the sum used by the foreign government as a base to compute the foreign tax." *United Dyewood Corp.* v. *Bowers*, 56 F.2d 603 (2d Cir. 1932). It has to be "entirely clear" to anyone who reads the words: a foreign corporation's "total taxable income" is not determined according to the tax laws of the United States.

In the Revenue Act of 1921 the deemed-paid credit was significantly changed, for the reason explained in *American Chicle Co.* v. *United States*, 316 U.S. 450, 453-54 (1942). The Court said that the difficulty with the original 1918 version of the deemed-paid credit was that it did not allow for matching the tax paid with the dividends received: "if dividends were paid out of surplus earned in prior years, and it happened that the subsidiary paid no tax to the foreign country in the year in question [when dividends were paid], the parent could claim no credit whatever." *Id.* at 453. The changes made in 1921 permitted "identification of the accumulated profits of each taxable year out of which the dividends might have been paid" and thus the giving of "credit for a proportion of the subsidiary's taxes attributable to such accumulated profits." *Id.* at 454.

Thus, Section 238(e) of the Revenue Act of 1921, 42 Stat. 259, introduced the term "accumulated profits" in order to permit the "sourcing" of dividends paid in year X to the profits of a previous year A, B or C when a foreign tax was paid. "Accumulated profits" continued to be related, in just the same way "total taxable income" had been, to the foreign income taxes for which credit was to be given; they were what the foreign taxes were "paid . . . upon or with respect to." The term accumulated profits was defined substantially as it is in Section 902(c)(1)(A) (except that accumulated profits initially denoted an after-tax amount, see P. 9 n. 2, *supra*). It was defined as the amount of the foreign corporation's "gains, profits, or income in excess of the income . . . taxes imposed upon or with respect to such profits or income."

The change effected in 1921 was a major one. But there is no hint that Congress, in making the change, meant that accumulated profits, unlike the predecessor "total taxable income," were to be calculated by the application of United States tax laws and not foreign tax laws. Indeed, this Court said in *American Chicle* that " 'accumulated profits,' . . . by definition, are [the foreign subsidiary's] total taxable profits less taxes paid." 316 U.S. at 452. "Total taxable profits" is close to "total taxable income," the 1918 statutory term, and that, as the Second Circuit said, was "the sum used by the foreign government as a base to compute the foreign tax." 56 F.2d at 603. At no later stage in the history of reenactments and amendments that produced the version of Section 902(a)(1) applicable in 1970 and 1971 is there a suggestion that accumulated profits meant not a foreign corporation's foreign tax base but its income or profits artificially determined according to United States tax rules.

II. ONLY THE DETERMINATION OF ACCUMULATED PROFITS BY FOREIGN TAX RULES ENABLES SECTION 902(a)(1) TO SERVE ITS PURPOSES.

At the most general level, the purpose of Section 902 is to prevent double taxation. More specifically, Section 902(a)(1) has the purpose of ensuring that the deemed-paid

credit is for an amount that reasonably reflects the foreign tax borne by the income used to pay to the dividend and, thereby—a third and final purpose on which the Government lays great stress (Gov't Br. 26-32)—making the United States income-tax treatment of a domestic corporation that owns or has an interest in a foreign corporation as nearly as possible the same as that of a domestic corporation that operates overseas and pays income taxes directly to a foreign country.

The Government says that only if the accumulated profits of the Section 902(a)(1) formula are measured according to United States standards will these purposes be achieved. To the contrary, it is demonstrable that the purposes are achieved only if "accumulated profits" are determined by applying foreign tax standards.

A. If Accumulated Profits Are Not Determined by Foreign Tax Law Standards, Double Taxation May Result.

Determining accumulated profits by United States tax rules does not reliably prevent double taxation; using foreign tax rules to determine accumulated profits does. When United States tax rules are applied to measure the accumulated profits of a foreign subsidiary, a domestic corporation may be left without a deemed-paid tax credit even though it has received a dividend from the subsidiary, the dividend has been taxed by the United States, and the profits that yielded them have been taxed by the subsidiary's home country. That is the double taxation that Section 902(a)(1) is meant to prevent. There cannot be double taxation when the dividend-yielding, taxed profits are left as they were, defined by the foreign tax law.

The case that demonstrates that, when United States tax principles are applied, double taxation can occur is the typical case in which a difference between the application of United States tax rules and foreign tax rules to determine a foreign corporation's income makes a difference in a particular tax year. That is, it is a case in which the

timing of income or deductions differs depending on which rules are applied. In this respect, it resembles Goodyear's case. A major item giving rise to the dispute between Goodyear and the Government was an item of timing, explained in the margin.[5]

Suppose, then, that a foreign subsidiary shows the following income and foreign tax over three years:

TABLE I

	Year 1	Year 2	Year 3
Annual Accumulated Profits (Foreign)	0	$1000	0
Foreign Tax	0	300	0
After-Tax Income	0	$ 700	0

Suppose, further, that United States tax law would record the $1000 of income in Year 1 rather than in Year 2. For United States purposes, the foreign subsidiary's income would appear as follows:

[5] Britain allowed rapid depreciation of assets, which reduces a corporation's net taxable income in the early years of an asset's life, as it did for Goodyear UK in 1973, but increases it in later years. The same total amount of depreciation expense will be recognized over time under the slower United States depreciation rule. Net taxable income if summed over several years will be about the same in either country. In addition, though not so clearly a matter of timing, Britain permitted Goodyear UK to reduce the value of its year-end inventory by the increase in its value during the year less 10 percent of trading profit for the year. Under the British law at that time, there was a "claw-back" provision so that, if the inventory dropped, the benefit of the inventory deduction would be lost.

TABLE II

	Year 1	Year 2	Year 3
Annual Accumulated Profits (U.S.)	$1000	0	0
Foreign Tax	0	($300)	0
After-Tax Income (Loss)	$1000	($300)	0

The foreign subsidiary has $700 available for payment to its parent as a dividend. The Government's contention that accumulated profits are measured according to United States rules would match this dividend, whenever it was paid, with *zero* foreign tax, the foreign tax that the corporation paid in Year 1, to which the Government would assign the $1000 of accumulated profit. Worse, the Government would match the $300 foreign tax paid in Year 2 with a *zero* amount of accumulated profits, so that this foreign tax would *never* be creditable. If the Government's approach were followed, the United States shareholder would obtain *no* foreign tax credit. The foreign tax would be trapped in a year without accumulated profits, by the Government's measurement of them, so that there could never be a credit for the tax. The phenomenon does not—cannot—occur when accumulated profits are measured by foreign standards. When that is done, the foreign tax and the accumulated profits are necessarily recorded in the same year, and the dividend, whenever paid, is related to accumulated profits of a year in which a foreign tax was paid to credit against the United States tax on the dividend.

Thus, when accumulated profits are computed according to United States tax rules, Section 902(a)(1) can and sometimes does fail its basic purpose of preventing double taxation. It also fails, as we shall next see, its more specific purposes of properly measuring the amount of tax attributable to the dividend and of treating the United States corporation with a foreign subsidiary like the United States corporation with a foreign branch.

B. Corrected and Expanded Versions of the Government's "Simple Examples" of the Workings of Section 902(a)(1) Show That Measurement of Accumulated Profits by Foreign Tax Rules Is Necessary to Achieve the Specific Purposes of the Section.

The Government attempts to explain the workings of the Section 902(a)(1) formula with "some simple examples." (Gov't Br. 4 n.3.) It uses these same examples to illustrate what it contends are the distortions produced by measuring accumulated profits according to foreign tax principles (*id.* at 21-22) and why measuring them according to United States tax principles is necessary to ensure equal treatment of the corporation that owns a foreign subsidiary and the corporation that operates a branch abroad (*id.* at 31-32). These "simple examples" illustrate nothing useful because they embody an elementary misstatement of what an income tax is. In the Government's examples the absolute amount of the foreign tax ($20) stays the same even as foreign taxable income rises from $100 to $180 and then dips to $60. No foreign income tax works that way. They are all percentage taxes, like the United States income tax. When the Government's mistake is corrected, the Government's examples illustrate our point, not its.

The Government begins with a base case in which accumulated profits are the same whether measured according to United States or foreign tax rules:

TABLE III

Accumulated Profits (Foreign & U.S.)	$100
Foreign Tax	20
Dividend	80

The foreign tax credit in this case is 20(80/(100-20)) or $20.

The Government then changes the base case, first to increase the amount of accumulated profits by foreign rules

to $180 while such profits by United States rules remain at $100.

TABLE IV

Accumulated Profits (Foreign)	$180
Foreign Tax	20
Dividend	80

The foreign tax credit in this case, if foreign rules define the accumulated profits of the denominator of the Section 902(a)(1) fraction, is 20(80/(180-20)) or $10. But if, as the Government urges, that is too small a credit compared with the base case credit of $20, when United States-defined accumulated profits and the amount of the dividend are the same as in the base case, it is not because there is anything wrong with the use of the foreign-law based $180 as the accumulated profits of the denominator. It is because the foreign tax in this case would not have been $20 but, at the 20-percent rate implicit in the base case, $36 (20% x 180).

Corrected to retain the 20-percent tax rate and not the absolute tax of $20, this second case yields a foreign tax credit of 36(80/(180-36)) = $20. A credit of $20 matches the credit in the base case and is perfectly appropriate when United States earnings and profits (before tax) are $100, the foreign tax rate is 20 percent, and all the available profits are distributed as a dividend. We would add that, when the remaining accumulated profits of $64 were paid out, the distribution would not constitute a dividend and the remaining $16 of foreign tax, quite appropriately under the statute, would not result in any foreign tax credit.

The Government's second modification assumes accumulated profits measured by foreign rules of less than the $100 of the base case:

TABLE V

Accumulated Profits (Foreign)	$60
Foreign Tax	20
Dividend	40

The foreign tax credit is 20(40/(60-20)) = $20. The Government suggests that a credit of $20 is too high, because it equals the credit allowed in the base case, even though only half of the after-tax United States profits of $80 have been distributed as a dividend. But in fact that credit of $20 is due not to the determination of accumulated profits by foreign rules but to the increase in the foreign tax rate, from 20 to 33 percent, that the Government has, probably unwittingly, smuggled into its example. If that error is corrected, and the foreign tax rate of 20 percent is retained, the foreign tax becomes $12 (20% x 60). If, in addition, we assume as the Government seems to assume that all of the foreign-determined earnings after tax (and no more) are paid out as dividends, the dividend is $48 (60-12) and the foreign tax credit is then 12(48/(60-12)) or $12, which for reasons explained in the margin bears just the relationship to the $20 credit of the base case that it should.[6]

There is another flaw in the Government's series of examples. They are static, single-year examples. As can be understood from the *American Chicle* opinion, the very reason for the introduction of "accumulated profits" into the deemed-paid tax credit provision of the tax code was to account for the fact that dividends are often paid out

[6] The foreign corporation in the base case distributed 100% of its after-tax profit (80 = 100 - 20) and obtained a foreign tax credit of $20. The Government suggests that a credit of $20 is too high in its second modification of the base case, where less than the full amount of earnings and profits are distributed. In the modification as we have corrected it, 60% of the base-case after-tax profits (48 = 60% x 80) are distributed so that the appropriate foreign tax credit relative to the base case is 60% of 20 (the base case credit) or $12.

in a year other than a year in which the profits supporting them were earned and taxed. (Pp. 13-14, *supra*.) A single-year example cannot take account of that phenomenon.

Moreover, unless one uses multi-year examples, one does not come to grips with the preponderant kind of issues whose resolution depends on whether accumulated profits are measured by United States or foreign tax principles—issues arising from differences in the year to which the law assigns income or deductions. The Government's one-year examples indeed do not come to grips with the issue in this case, where the Inland Revenue allowed Goodyear UK deductions earlier than the Internal Revenue Service would have allowed them to a United States taxpayer. (P. 16 n. 5, *supra*).

We can turn the Government's sterile one-year examples into a useful multi-year example by just a few modifications. We take the second variation of the Government's base case, where the foreign taxing jurisdiction allows a $40 deduction that the United States does not allow—presumably ever—and assume more realistically that the issue is one of timing. We assume that the deduction will be allowed by the United States but in a later year. We retain the same 20-percent foreign tax rate that the Government probably meant to assume, and we accept its assumption that the foreign subsidiary pays all its net income, after foreign income taxes, to the United States parent each year.

The multi-year example (which, mathematically, need only be a two-year example, Year 2 standing for any and all subsequent years) demonstrates that, if accumulated profits are measured by foreign tax rules, double taxation is prevented and the subsidiary purposes of Section 902(a)(1) are also served. The foreign tax credit is fairly proportional and is as near as inherent differences in the two ways of doing business permit to the credit that a United States corporation with a foreign branch would receive. The same things are not true if accumulated prof-

its are measured as the Government would measure them, according to United States rules.

The demonstration begins with the following table, which shows, up to the point of the tax credits, the results of varying the year in which a deduction is allowed.

TABLE VI

	Year 1	Year 2
Gross Income[7]	$100	$40
Deduction		
Foreign Timing	(40)	
U.S. Timing		(40)
Foreign Accumulated Profits	60	40
U.S. Accumulated Profits	100	0
Foreign Taxes	12	8
Dividend Paid	48	32

Before we compute the credit for foreign taxes paid by a subsidiary with these results, we note that the foreign tax credit of a United States taxpayer realizing results similar to these through a foreign branch would equal the foreign tax imposed in each year. The taxpayer might be subject to a limitation on the foreign tax credit in Year 2 because of the branch's failure to produce income taxable by United States standards, but the excess credit would be carried back to the first year. Assuming a United States income tax rate of 40 percent, the taxpayer's United States taxes from its foreign branch operations would be figured as follows:

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[7] In the Government's base case the foreign subsidiary's net income, or accumulated profits, is $100 under the rules of either taxing regime. In this example we retain that premise but extend it over time by treating the $40 deduction of the Government's variation of the base case (assumed, for simplicity, to be the only deduction) as allowable by foreign rules in Year 1 and by U.S. rules in Year 2. There must therefore be $140 of gross income to yield $100 of total net income over two years under both regimes.

TABLE VII

	Year 1	Year 2
U.S. Taxable Income	$100	0
Tentative U.S. tax	40	0
Foreign Tax Credit (Year 1)	(12)	0
Foreign Tax Credit (Year 2 carryback)	(8)	0
Net U.S. Tax	$ 20	0

If foreign tax rules determine what accumulated profits amount to, then, over the two years of our example, the Section 902(a)(1) formula yields for the corporate parent of a foreign subsidiary that distributes its after-tax foreign profits in full each year a tax credit of $20, the same as the tax paid and the credit received by the United States corporation with a foreign branch. The credit in Year 1 is the foreign tax of $12 multiplied by a fraction consisting of the dividend of $48 over accumulated profits of $60 minus the foreign tax of $12; the fraction is 1 and the credit is for the full amount of the foreign tax, $12: 12(48/(60-12)) = 12. Similarly, in Year 2: 8(32/(40-8)) = 8, and again the credit is for the full amount of the tax, $8; finally, $12 + $8 = $20.

This is *not* true if United States tax rules govern the timing of the deduction. In that case Table VI shows accumulated profits of $100 in Year 1 and 0 in Year 2, and the formula yields:

Year 1: 12(48/(100-12)) = $6.55.

Year 2 (that year's dividend of $32 is assigned to the accumulated profits from Year 1):

12(32/(100-12)) = $4.36.

The credit over the two years ($10.91) is thus only a little more than half what it should be.

The point is driven home by a comparison of the total United States income tax burden of the corporate parent whose subsidiary's accumulated profits are determined according to (1) foreign law and (2) United States law.

TABLE VIII

(1) Foreign Law	Year 1	Year 2	Total
U.S. Taxable Income	$48	$32	
Gross-up for Foreign Taxes Paid*	12	8	
Tentative U.S. Tax @40%	24	16	
Foreign Tax Credit	12	8	
Net U.S. Tax	$12	$ 8	$20

(2) U.S. Law	Year 1	Year 2	Total
U.S. Taxable Income	$48.00	$32.00	
Gross-up for Foreign Taxes Paid	6.55	4.36	
Tentative U.S. Tax @40%	21.82	14.54	
Foreign Tax Credit	6.55	4.36	
Net U.S. Tax	$15.27	$10.18	$25.45

If accumulated profits are defined according to foreign law, the United States taxpayer receives the credit to which it is entitled and pays the United States tax, after credit, that it should. The only difference between the treatment of that taxpayer and the taxpayer with a foreign branch is a difference that is inherent in the choice to do business in one form or the other; sometimes the timing of the receipt of income and therefore of the tax credit will differ depending on the choice made. On the other hand, if accumulated profits are determined according to United States law, the taxpayer that does business through a subsidiary pays a wholly unwarranted penalty and suffers

* Grossing-up, the addition to United States income of the foreign income tax deemed paid by a dividend recipient, is explained by the Government at page 23 n.10 of its brief.

by comparison with the taxpayer that does business through a branch. It receives less of a credit over the two relevant years than it is entitled to, and it thereby suffers double taxation to the extent of the credit it loses. In our example, it pays a total tax of more than 45 percent of its income from the subsidiary instead of the maximum of 40 percent that it should have to pay.

There is no way of avoiding the logic of the example that shows this result. There will be comparable or different distortions whenever United States tax principles are used to determine the timing of income and deductions that are different from the foreign principles that determine the timing of the foreign tax. The tax will inevitably be divorced from the income on which it is imposed and the dividend that the income makes possible, and that inevitably will distort the amount of the credit. On the other hand, if foreign law determines accumulated profits, there will be no distortions or "windfalls," notwithstanding the Government's assertions to the contrary (Br. 45-46). This is so because the "deemed-paid" credit that can be claimed cannot exceed the amount of the foreign tax actually paid, and the credit cannot be allowed before the foreign tax is paid.

III. THE TREASURY REGULATION PURPORTING TO DEFINE ACCUMULATED PROFITS IS CONFUSED AND INCONSISTENT WITH THE STATUTE, AND THERE IS NO SETTLED JUDICIAL CONSTRUCTION OF THE PHRASE.

The Government cites the Treasury Regulation issued under Section 902 defining "accumulated profits" and asks for deference to it as implementing "the congressional mandate in some reasonable manner," *National Muffler Dealers Ass'n* v. *United States*, 440 U.S. 472, 476 (1979), and as "harmonious with the governing statute" (Gov't Br. 35, citing 440 U.S. at 477). For at least two reasons, no deference is owing. First, the regulation, Treas. Reg. § 1.902-3(c)(1) in the years in issue (Gov't Br. 4a), is confused and confusing, and, second, if taken to say what the

Government seems to urge that it says, it is hopelessly inconsistent with the statute it purports to interpret.

Section 1.902-3(c)(1) says that a foreign corporation's accumulated profits are the sum of its earnings and profits for a year and the foreign taxes "imposed on or with respect to the gains, profits, and income to which such earnings and profits are attributable." The confusion arises from the regulation's use in a definition of "accumulated profits" of the phrase "gains, profits, and income," which is itself, by statute, the definitional equivalent of "accumulated profits." The regulation does not undertake to define "gains, profits, and income," although the phrase is used again in the regulation, after its use in the definition of "accumulated profits." *See* Treas. Reg. § 1.902-3(c)(4) (1971 ed.).

The confusion thus engendered is well illustrated by the Claims Court's exegesis of the regulation. The Claims Court, bear in mind, decided for the Government and even thought the regulation supported its decision. (Pet. 26a.) But it said that "[t]his regulation clearly distinguishes 'earnings and profits' from 'gains, profits and income' " and that "[t]he relation of 'gains, profits and income' to foreign income taxes indicates this tax concept is to be equated with foreign taxable income." (Pet. 25a-26a.) The court is quite right, of course, but it could not have realized the implication of what it was saying. For, if what it said is so, then "accumulated profits" too must be equated with "foreign taxable income" because accumulated profits, by statutory definition, are the equivalent of "gains, profits, and income."

What the confusing definition means, with its gratuitous introduction of "earnings and profits" into what would otherwise be a restatement of the statutory definition, is most unclear. But if it is meant to equate earnings and profits and accumulated profits, it is inconsistent with Section 902 for all the reason detailed in Part I of our argument. Those reasons are aptly summed up in the Claims Court's statement that gains, profits and income (and thus,

we would add, accumulated profits) are "to be equated with foreign taxable income." In particular, if the regulation's purport is that United States earnings and profits enter into accumulated profits, it ignores the fact that in 1962, just before the regulation was written in 1965, Congress had deliberately declined the opportunity to make Section 902 the twin of the new Section 960 by writing it in terms of earnings and profits. (Pp. 11-12, *supra*.) The regulation is not a reasonable construction that should even begin to command this Court's deference. It is a thoroughgoing reconstruction of the statute. This Court has rejected as unreasonable and inconsistent with the underlying statute far less egregious Treasury interpretations of the Code. *United States* v. *Vogel Fertilizer Co.*, 455 U.S. 16, 26, 30 (1982); *Rowan Cos.* v. *United States*, 452 U.S. 247, 263 (1981); *Northeastern Pennsylvania Nat'l Bank & Trust Co.* v. *United States*, 387 U.S. 213, 218 (1967); *Commissioner* v. *Acker*, 361 U.S. 87, 93-94 (1959).

The Government says that the 1965 regulation "reflects a position first announced by the Treasury more than 55 years ago." (Gov't Br. 35.) Not so. The 1933 pronouncement to which the Government refers did say that accumulated profits must include "all income of the foreign corporation available for distribution to its shareholders, whether such profits be taxable by the foreign country or not." I.T. 2676, XII-1 C.B. 48, 50 (1933), *declared obsolete by* Rev. Rul. 70-293, 1970-1 C.B. 282. It did not say that such all-encompassing income was to be measured by United States tax laws. It did not say that accumulated profits are the equivalent of earnings and profits, as familiar and as meaningful a shorthand phrase in United States tax law in 1933 as it is today. In speaking of a computation that would yield all of a foreign corporation's "distributable income or surplus," I.T. 2676 might very reasonably have been speaking of distributable income as determined under foreign law.[9]

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[9] Whether "accumulated profits" include income that is not taxable by foreign law but by that law is available for distribution to share-

The inconclusive I.T. 2676 was not the first, most nearly contemporaneous, word from the Treasury or the Service on the meaning of "accumulated profits" after it became a part of tax law in 1921. Until 1933 the Treasury Department forms that a taxpayer filed to claim the deemed-paid tax credit clearly directed that the taxpayer use foreign taxable income as the denominator in the proration formula, first under Section 240(c) of the Revenue Act of 1918 as the "total taxable income" of that statute, and then, more significantly, as the equivalent of the "accumulated profits" of Section 238(e) of the Revenue Act of 1921. *See* Gallagher, *A Will-o'-the-Wisp in the Indirect Foreign Tax Credit: The Term "Accumulated Profits"*, 12 Tax Executive, 291, 306-08 (1960). After 1933 these forms accorded with the ambiguous I.T. 2676, still not specifying the use of United States tax law to define accumulated profits.

A 1963 ruling (Gov't Br. 33-34) did state that "the criteria applicable to the determination of 'earnings and profits' are equally applicable to the determination of 'accumulated profits.' " Rev. Rul. 63-6, 1963-1 C.B. 126, 128. But that ruling, which a careful contemporaneous reader said did not equate earnings and profits and accumulated profits,[10] was declared to be obsolete by Rev. Rul. 72-621, 1972-2 C.B. 651, whether because of the promulgation of the superseding 1965 regulation or for some other reason. The 1965 regulation is the only present authority. Not surprisingly, administrative rulings since 1965 have parroted or cited it (Gov't Br. 34) even as they have striven to reconcile the equation of "earnings and profits" and "accumulated profits" with the policy of avoiding double taxation. *E.g.*, Rev. Rul. 74-310, 1974-2 C.B. 205; Rev.

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holders—something comparable to our municipal bond interest—is not an issue in this case. It is by no means a recurrent issue and, given the 1986 amendment of Section 902 (Gov't Br. 39 n.17), it is an issue that this Court very likely will never have to confront.

[10] *See* Schoenfeld, *Some Definitional Problems in the Deemed Paid Foreign Tax Credit of Section 902: "Dividends" and "Accumulated Profits"*, 18 Tax L. Rev. 401, 418-19 (1963).

Rul. 71-65, 1971-1 C.B. 212; G.C.M. 36814 (Aug. 18, 1976) (LEXIS, Fedtax library, Rels file). Those rulings in any event add no weight to the authority of the regulation. The Government's case for deference to an agency interpretation stands or falls with the tortured regulation.

The issue that the Federal Circuit decided in this case was an issue of first impression for federal courts, including the Tax Court. In some cases where the issue has differed from what it is here, there are dicta that quote or cite the Treasury's regulation. In the one case on which the Government relies that preceded the regulation, *Steel Improvement & Forge Co.* v. *Commissioner*, 36 T.C. 265, 277 (1961), *rev'd*, 314 F.2d 96 (6th Cir. 1963), it is clear from the entirety of a passage that the Government quotes in part (Gov't Br. 37 n. 15) that the court was saying something wholly noncontroversial and not something that supports the Government's argument here. The court said that, "*in determining the character of the dividends received by residents of the United States from foreign corporations*, the accumulated earnings and profits from which the dividends are paid are to be determined under American rather than foreign law." (Italicized words omitted from Government's brief.) That is a proposition with which no one quarrels.

The views of commentators on the issue (*see* Gov't Br. 38 n.16) have varied.[11] Whatever has gone before, it is now clear, on the sustained textual and policy analysis that this case by posing the issue squarely has demanded, that only the measurement of accumulated profits by foreign-law standards fits the text of the statute as the text is illuminated by context and history; it is now clear that only the measurement of accumulated profits by foreign-law standards enables the statute to serve its bedrock purpose of matching foreign profits, taxes, and dividends in such a way as to ensure to the United States corporate

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[11] Compare two extended treatments: *Gallagher*, *supra* ("accumulated profits should be equated to foreign taxable income," 12 Tax Executive at 328), *with* Schoenfeld, *supra* note 10 at 407-21 (unspecified "American concepts must be used in defining" the term, *id.* at 420).

taxpayer a credit fairly proportionate to the dividend it receives and the foreign tax paid in respect of it.

CONCLUSION

The judgment of the Court of Appeals for the Federal Circuit should be affirmed.

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